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DOW THEORY LETTERS

"THE MARKET AS INTERPRETED UNDER THE DOW THEORY"

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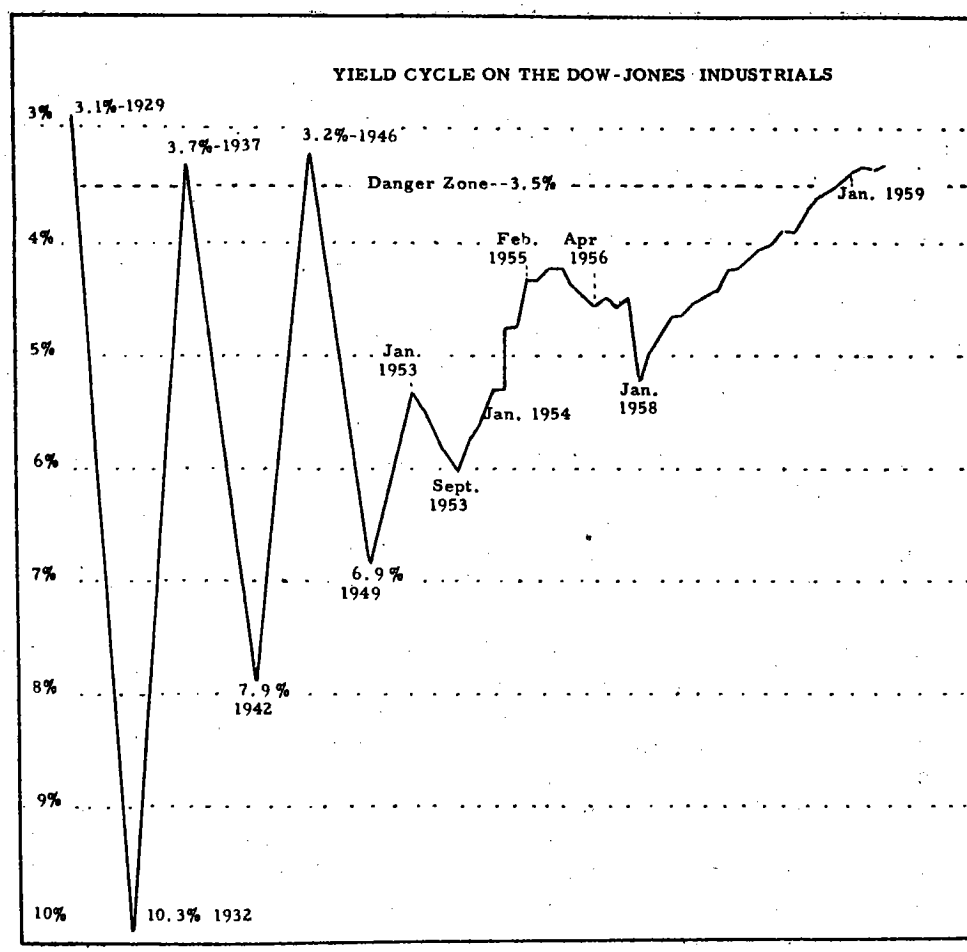
VALUES. I have included a chart with this Letter which traces the yield on the Dow-Jones industrials back to 1929. This is an important study, and one which is an integral part of the Dow Theory. Many students lay such emphasis on price movements and penetrations that they fail to realize that Dow and Hamilton attached the utmost importance to values. "Stocks fluctuate together," observed Dow, "but prices are controlled by values in the long run." One of the most significant tests of value is yield, or how much a stock will return to the investor who has assumed the risk of owning a share in the company. The yield-cycle chart shows that the average yield of stocks, as measured by the D-J industrials, tends to run to extremes. At the lows of the 1932, 1942, and 1949 bear markets, yields were very attractive and stocks were selling on the bargain counter. As is usually the case, volume during each of these periods was running around a million shares a day or less. This suggests that the public was singularly unaware of the great values in investment grade stocks during these times. "Blue-chips" yielding an average of 6.9% to 10.3% tend to be in or near a buying zone, but they are attractive only to informed investors, the type who buy the market at the bottom when the crowd "will not touch a share."

In 1902 Dow wrote: "When a stock sells at a price which returns only about 3-1/2% on the investment, it is obviously dear, except there be some special reason for the established price. In the long run, the prices of stocks adjust themselves to the return on the investment, and while this is not a safe guide at all times, it is a guide that should never be laid aside or overlooked." The chart will demonstrate that when the average yield enters the general vicinity of 3.5%, investors have tended to be sellers. Once in the danger zone (marked on chart), the informed investor gradually unloads his securities on an eager public--the same public who would not hear of stocks when they were cheap and on attractive yields. It is incredible that Dow's original observations concerning stock values should have proved so accurate. Eventually, when sufficient distribution has taken place, stocks top out in the danger zone (3.5% or less); and the next bear market begins. I am willing to concede that stocks may stay forever in the 3.5% area, but I feel safer when I operate on the lessons of history and Charles H. Dow. Based on the record of 14 bull markets dating back to 1896. equities are now in that area where informed investors tend to be sellers, not buyers.



I believe that if Dow, Hamilton, or Rhea were living today, they would be cautious, they would not be in 100% equity, and they would be placing the end of this bull market no more than a year to a year and a half away. Much will depend, of course, on how speculative things become from this point on, how quickly the

public comes in, and how fast it spends its money. An international scare or government controls at this juncture could prolong the bull market, not stop it.

PRIORITY. The study of values brings up a crucial question: under Dow Theory, do we give priority to values or to the averages? This is an area which few people understand, but it is one which is essential to grasp at this time. According to the Dow Theory as I have read it and studied it, when a bull market is in its third phase, when volume is surging to new highs, when speculation is rampant and when values are non-existent, we guess that the end is near and we sell out. We never wait for the actual bear signal. I want to state now that I will be very happy to be in a 100% cash position at a point 10% from the final top. I was in 100% equity up to January of this year but have since reduced my ratio to about 55% stocks. I expect to increase my cash position continually as this market works higher. And at an arbitrary point (I have picked the end of this year if not before), I want to be completely on the sidelines. From then on this bull market is going to have to go its way without me.

I have explained in previous letters that the validity of bullish signals decreases as a bull market matures. Each signal carries progressively less authority until the final signal which may predict a single day of higher prices before a primary bear market sets in. Therefore we necessarily give the highest priority to values and the market's technical position near the highs of a bull market, regardless of the fact that the averages are saying that we are still in a primary bull market.

HOW HOT IS HOT? Diverse opinions are being voiced concerning the current heated speculation on the exchanges. Conservative investors are shaking their heads as they watch the high-flying quotes cross the ticker tape each day. The old axiom, "Buy the 'blue-chips' and put 'em away for the kids" has not stood up too well during the last year. Had one put $450.00 into the investment-grade D-J industrials a year ago he would now have about $615.00. $450.00 placed in Barron's Low Priced Index would show $900.00 over the same period of time. To students of the Dow Theory this was the expected turn of events; to the amateur it represents an incredible state of affairs.

Conservative analysts and investors, disturbed by the speculative intensity of the market, are guessing that the end is near. "The market must be topping out," they warn, "Haven't we been taught that poor leadership heralds the end of the move?" Actually, the market may be likened to a balloon; it may appear to be at the bursting point, but who is to say whether it cannot stretch to twice its present size before the "pop" occurs? We do know that there is a limit to inflation, whether in balloons or stocks, and the more rapid the expansion, the sooner the explosion.

Hamilton insisted that the duration or extent of a move could not be predicted in advance. Few people envisioned anything like the 200 point 17 month advance which has marked the market's action since the October, 1957 lows. Consequently, in areas like the present one, Dow Theorists can only hold their breaths and turn cautious as the market climbs higher.

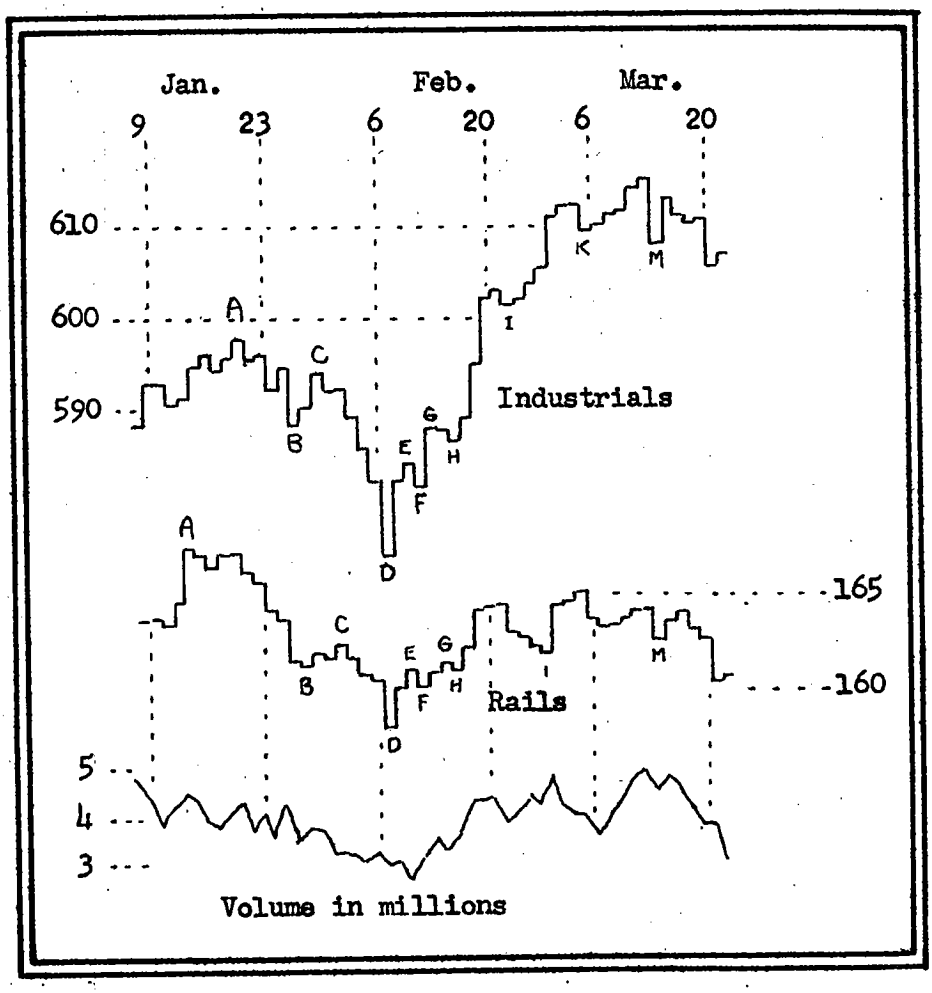
Bull markets usually end when the public has spent its money. A basic principle of technical analysis says that it requires constant buying to advance stocks (or hold them up), but they fall of their own weight. Therefore, while there are still large reserves of cash to be spent, the market may hold or advance. But when the money is spent the "cradle will fall," and it will not stop falling until the informed investor comes in again with his dollars.

IS THE MONEY SPENT? Despite all the talk of unbridled crowd participation, the odd-lot buying during the last eight weeks has been clipping along with only a small margin on the "buy" side. There has been no upward curve in odd-lot purchasing as is usually the case during a bull swing. This fact indicates that the market may not be overbought. The total short interest remains impressive (3,793,000); evidently, a large number of people continue to believe that this market is headed lower. The short interest-average daily volume ratio is .94, the lowest since January, 1958, but it remains in the neutral zone. It is very probable that near the top of this bull market the short interest will be near 2 million shares (or less) as it was at the 1956 highs.

Volume in the last few months has averaged around 3-1/2 to 4-1/2 million shares per day. This is significant when compared to other extended bull markets. Although no two bull markets are identical, a study of previous markets suggests that bull swings end on high volume, often on higher volume than anything previously seen during the move. In 1929 Rhea estimated that about half the transactions on the exchange represented floor trading. But because of the S.E.C.'s elimination of "pool" operations and overt manipulation, the percentage of floor transactions has been considerably reduced; it runs about 20% of total volume at present. If we consider that 50% of the 6-9 million daily shares that marked the 1928-29 excitement was public participation, we may say that the crowd represented 3 to 4-1/2 million shares of that climactic volume. If the public constitutes 80% of the volume today, then 2.8 to 3.5 million of the present volume represents the public. But the population today is 175 million as compared to 122 million in 1929, or 43% greater. If the 1929 figures are adjusted for population increase, we might say that current volume should run about 5-1/2 to 8 million shares per day in order to equal the crowd participation of 1929.

We have not seen anything like 6-7-8 million share days during this entire 10 year bull market. Considering the fact that this is the greatest bull market on record, both in duration and extent, I believe it is logical to expect (adjusted) volume at least comparable to 1928-29 before a final topping out. This might mean many weeks (probably spaced in series of two or three weeks at a time) in which 5-1/2 to 8 million share days are commonplace.

REVIEW OF THE PRICE MOVEMENTS. Taken as a whole, the action of the market since the beginning of 1959 has been the most unsatisfactory, the most hesitant, and the most deceptive since the lows of October, 1957. From January 1st to the present, industrials have advanced about 20 points and rails about 3. For the investor who did not purchase speculative "cats-and'dogs" or specialties, it has been a profitless quarter. The rail average weakened in January after hitting a high of 167.38; it has not seen that price again. A low of 157.94 (point D, see chart) was struck by rails in February, and that point has held so far on the downside. Since their February lows of 574.46 (point D) industrials have made a valiant showing in advancing to a high of 614.69. The rails, although refusing to confirm, established a series of ascending bases which allowed Dow Theorists to expect an eventual topside break-out (confirmation) by the carriers. The rails, having stubbornly refused to better their January highs, were at least tending to move "in gear" or in the same direction as industrials. Since my last letter the rails have performed like a litter of sick puppies. They have violated every base but the minor one at F and their 1959 lows at D. On Monday (March 23) both averages violated the "line" which had formed since March 1st. So far, volume has not appeared as prices worked lower. This lack of downside volume plus the fact that one or both (both at this writing) averages have held above the February lows allows the Dow Theorist to sit, bite his fingernails, and hope.



If the two averages continue down and one or both hold above their lows at D, this market may yet

develop into something worthwhile. If, on the other hand, both averages violate their lows at D (particularly on increasing volume) we will say that the secondary trend has turned down at last, and that a reaction is probably in order. A 1/3 retracement of the uncorrected primary advance since October, 1957 would take industrials back to 548. A 2/3 retracement would take them back to 482. Both would go down in the books as typical secondary reactions. Needless to say, many secondaries have been milder than the typical 1/3 to 2/3 retracement.

It is interesting to note that this recent hesitancy has come in the face of the most bullish business news in a year and a half. There is little in the headlines to account for the hesitant performance of the market. But as has been the case throughout history, the emotionless averages are examining the evidence through the eyes of hundreds of thousands of investors. The eventual verdict will carry more weight than the bullish or bearish pronouncements of the President, the Congress, and the Federal Reserve taken together.

Long term investors may continue to sit on their holdings. The primary trend of stocks is up. Traders should watch the current price movements carefully. If the D lows are approached and volume diminishes on the decline, it will be a bullish sign. As long as one or both averages hold above the D lows it will continue bullish. If volume increases as the D lows are approached and they are then violated by both averages, prudent traders should lighten their portfolios and pay "insurance" against what could well be a secondary reaction. In the latter case, those readers who made purchases in the area of the suggested F and H buy-spots would sustain relatively minor losses.

STOCKS. Letter #59 noted that we were not in a buying area; the market seems no more attractive now. I would not make new commitments at this point because of the unsatisfactory price movements as discussed above. My choice of individual stocks remains about as listed in recent Letters. Kayser-Roth, Bond Stores, Robertshaw-Fulton and Emerson Electric (none of them high quality), all show up well on my charts.
(written March 25, 1959 - 9:00 p.m.)

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